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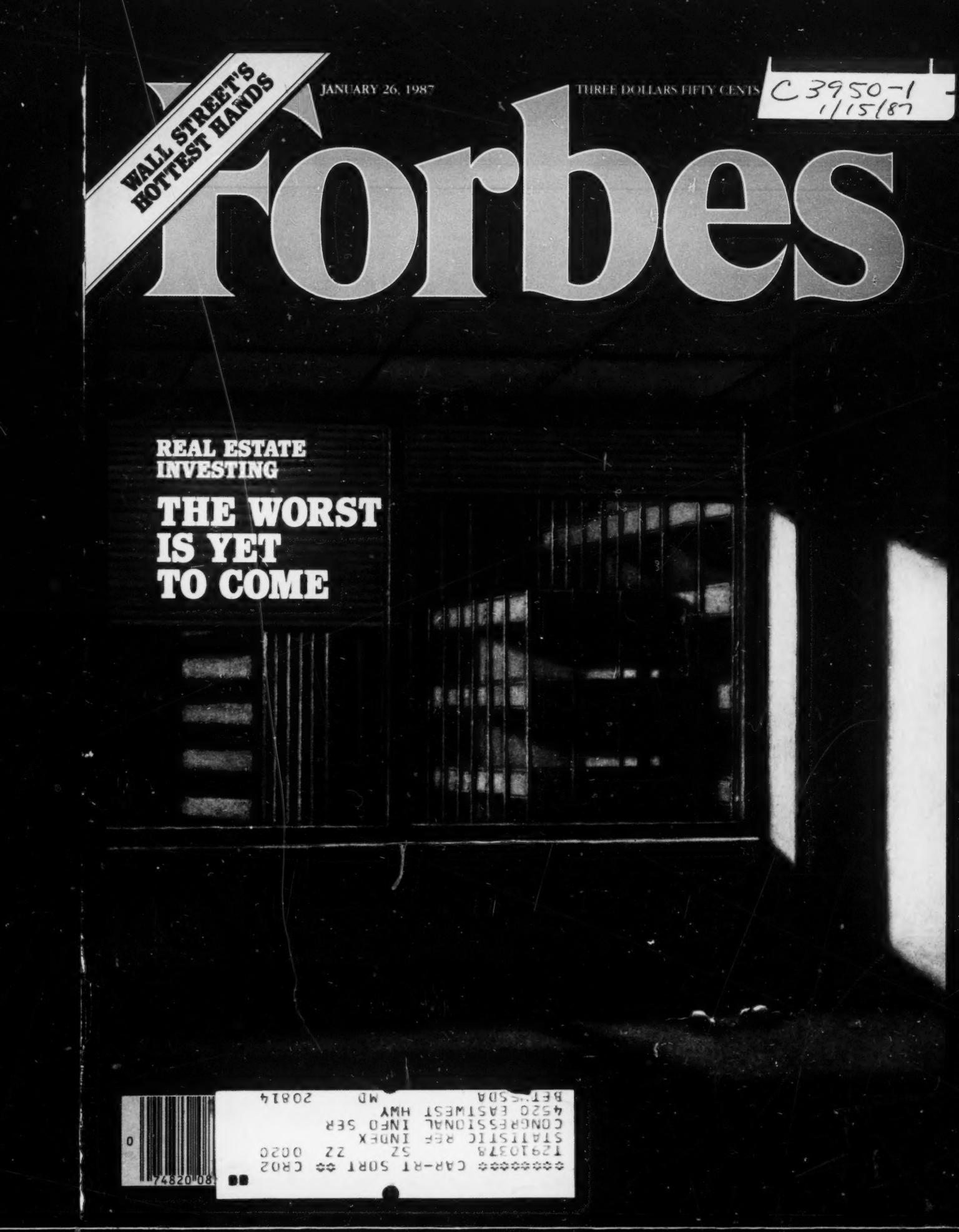
JANUARY 26, 1987

THREE DOLLARS FIFTY CENTS

WALL STREET'S HOTTEST HANDS

Forbes



REAL ESTATE INVESTING

THE WORST IS YET TO COME

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Forbes

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VOLUME 139
NUMBER 2

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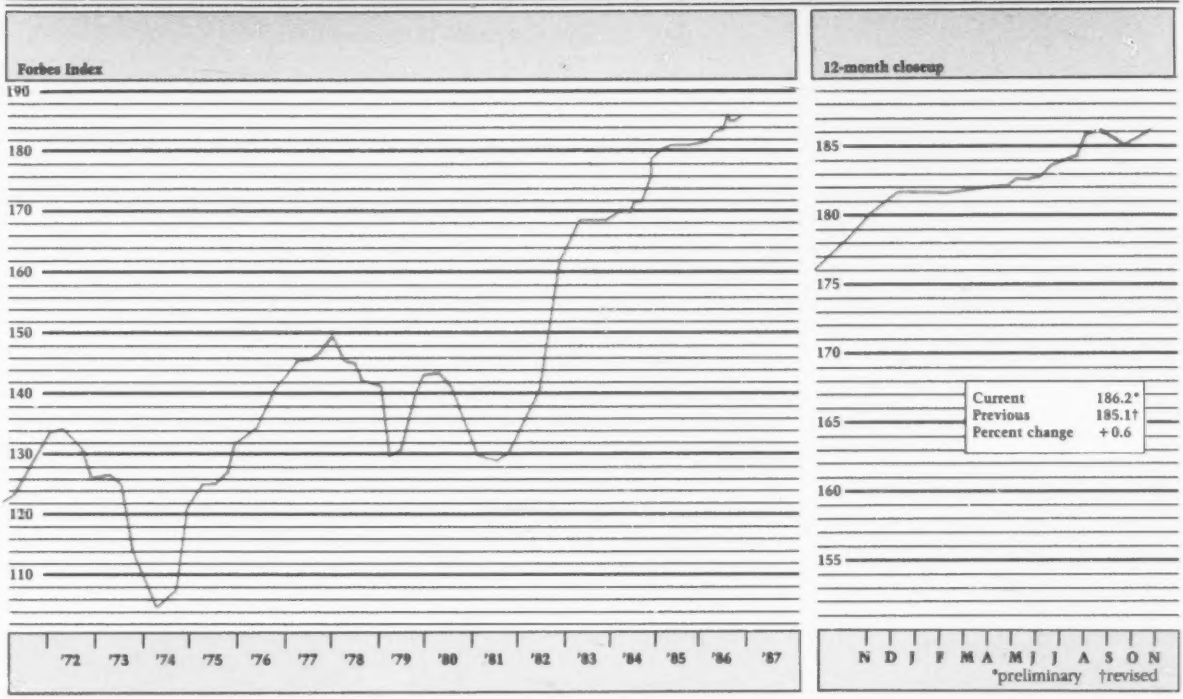
The Forbes Index



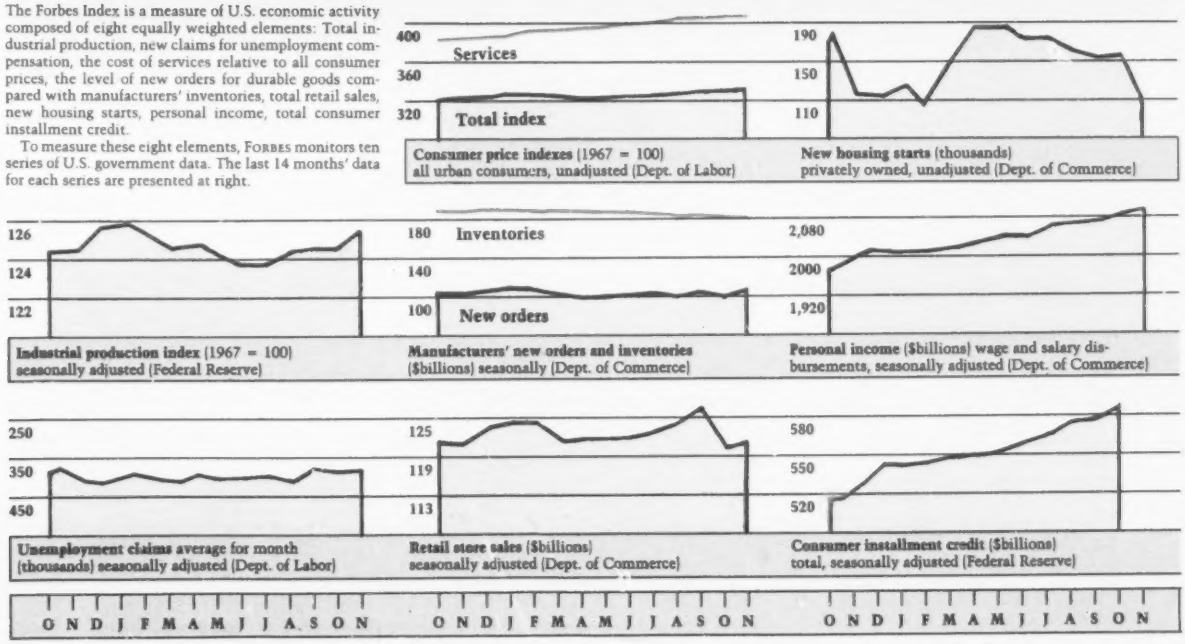
Defense spending boosts the Index. The Forbes Index rose 0.6% during November, following a 0.5% decline the previous month. Helping the Index get back on track was a 1.5% increase in the ratio of manufacturers' new orders for durable goods to inventories. From October to November durable goods orders climbed 5.5%, while inventories rose by 0.2%. But don't look for a big turnaround in manufacturing; the increase in durable goods orders was mainly the result of a burst of military spending.

Inflation remains in check. Despite a relatively weaker dollar that is raising the price of imports, the Consumer Price Index went up by only 0.1% in November. The services component of the CPI failed to post a gain for the first time since December 1982.

The Forbes Index Components

The Forbes Index is a measure of U.S. economic activity composed of eight equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, total consumer installment credit.

To measure these eight elements, FORBES monitors ten series of U.S. government data. The last 14 months' data for each series are presented at right.


400
Services
360
320
Total index
Consumer price indexes (1967 = 100) all urban consumers, unadjusted (Dept. of Labor)
190
150
110
New housing starts (thousands) privately owned, unadjusted (Dept. of Commerce)
126
124
122
Industrial production index (1967 = 100) seasonally adjusted (Federal Reserve)
180
Inventories
140
100
New orders
Manufacturers' new orders and inventories ($billions) seasonally (Dept. of Commerce)
2,080
2000
1,920
Personal income ($billions) wage and salary disbursements, seasonally adjusted (Dept. of Commerce)
250
350
450
Unemployment claims average for month (thousands) seasonally adjusted (Dept. of Labor)
125
119
113
Retail store sales ($billions) seasonally adjusted (Dept. of Commerce)
580
550
520
Consumer installment credit ($billions) total, seasonally adjusted (Federal Reserve)
O N D J F M A M J J A S O N
O N D J F M A M J J A S O N
O N D J F M A M J J A S O N

Foreigners and pension funds are paying enormous prices for prime buildings. But don't be fooled.

Commercial real estate— the worst is yet to come

By Richard L. Stern and Howard Rudnitsky

IN THE LATE 1970s Manhattan's prime commercial real estate was being unloaded for a rock-bottom $70 to $100 a square foot, and the pundits were wailing of market collapse and bankruptcy. Canada's shrewd Reichmann brothers poured more than $300 million into blue-chip city office properties on behalf of their Olympia & York Equity Corp. Those Reichmann properties are now worth far more than $1 billion. Today, too, with inflation way down and overbuilding rampant, commercial real estate prices have turned soft. But people peddling real estate are encouraging the thought that now is the time to buy. Be another Reichmann, they urge.

Don't take the bait.

Yes, we read the papers, too. The Japanese shelled out $600 million (a single-building record) for New York's Exxon Building and $620 million for the Arco Plaza twin towers in Los Angeles. But remember: These are exceptional properties purchased by people who can afford to overpay and who can hang in for the long haul.

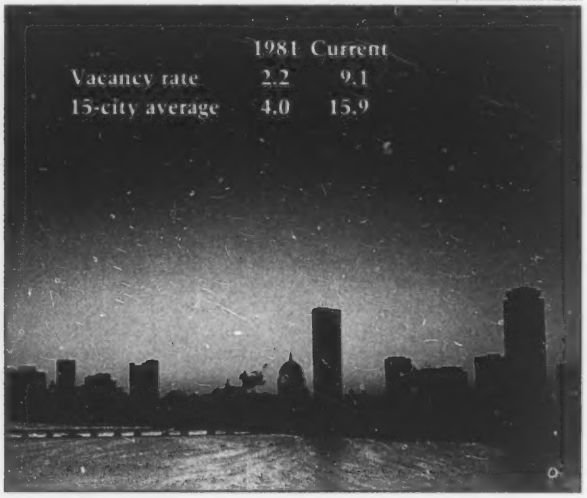
Then there are the rest, all of those none-too-exceptional properties, many heavily polluted with debt, that are the bulk of the nastiest and softest real estate market since World War II. They are the office buildings, hotels and shopping centers that were built, bought or sold often for no reason other than that the Wall Street wizards and financial packagers, with their debt-without-fear philosophies, could latch on to construction money. And for these, FORBES concludes, commercial real estate prices have yet to fully adjust to slowed inflation and overbuilding fueled by the old tax law.

Before this market turns, the defaults, fire sales and writedowns could well force a decline in real estate values, nationwide, that could reach $40 billion to $50 billion, greatly exceeding the wrenching losses of the mid-Seventies, which was the worst bust since World War II. "It looks like real estate's turn for a prolonged bear market

Steve Elmore/Click Chicago

Atlanta

Randy Duchaine/Stock Market



Boston

All vacancy rate data from Coldwell Banker for downtowns only.

into the 1990s, the same as it was for stocks and bonds in the 1970s," says Peter Aldrich, of the Boston real estate investment firm Aldrich, Eastman & Waltch.

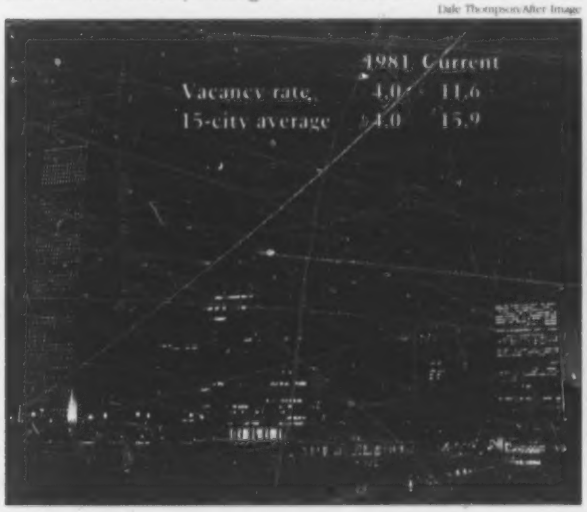
Some of the reasons will sound familiar. One, of course, is the sharp slowing of inflation. A lot of these buildings were sold on the basis not of current cash flow but of expected inflationary gains down the road. Another reason is the new tax law and its far less generous rules, which now make it more difficult to carry high-vacancy buildings. These two factors alone would have been enough to deepen the bust end of the real estate cycle.

But in prior periods of overbuilding, the money spigots were shut off by higher interest rates. This time, even through the 18% rates of the early Eighties, the cash continued to flow. The cry went up: You can't lose in good real estate.

There were more sources of money than ever before: syndicators, pension funds, insurance companies, foreigners and the banks, acting as investors as well as lenders. Syndicators and Wall Street's product development boys packed properties into zero coupon real estate bonds, limited partnerships and real estate investment trusts. Too many of these products spawned their own version of new math—rates of return based on dubious appraisals, unreal inflation estimates and unlikely occupancy rate projections; fantasy figures, based on the commercial real estate markets of a very different past. Even rent rolls were vastly overestimated at a time when sharp rent concessions were becoming the rule. Today, even in supposedly strong markets like New York, Boston and Philadelphia, discounting has become routine.

Sam Zell, a Chicago-based real estate entrepreneur who made a fortune buying distressed properties cheap during the 1970s, deplores what he calls "the commoditization of real estate." It was the idea that real estate was a commodity, like any other, that could be packaged and sold almost as if it were something fungible—as if one square foot of property were pretty much the same as any other. That

Dale Thompson/After Image

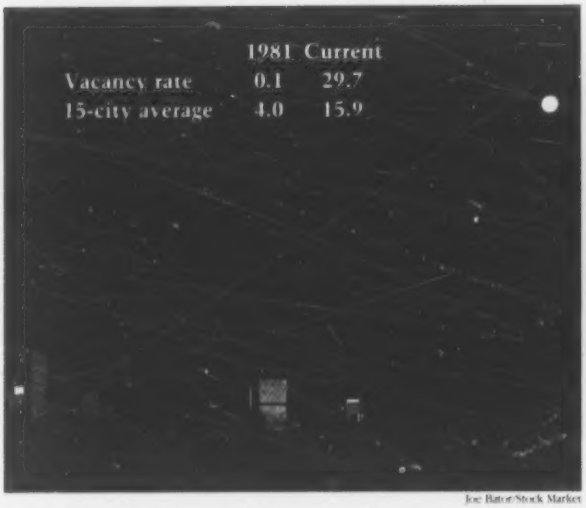


Chicago

David Barnes/Stock Market

Dallas

Denver



Joe Bator/Stock Market

was a little like saying that one stock was just as good as another, but such was the frenzy in real estate that few people bothered to question the idea.

Reliable old rules of thumb were discarded. Not so long ago it was routine to value an office building at seven times its rent roll. In the last five years, with acquisitive syndicators driving prices up, the number inflated to nine or ten times rent. Gone, too, was another old guideline: Rarely build downtown offices where the vacancy rates have edged above single digits. Big-city developers, recently, hardly blinked at 12% and broke ground all the same.

When the Reichmanns made their vaunted investment in supposedly overbuilt New York, the vacancy rate was an alarming 12%. These days 12% is a hot market, and there are very few of those. New York City, one of the few, is at 9.8% and rising.

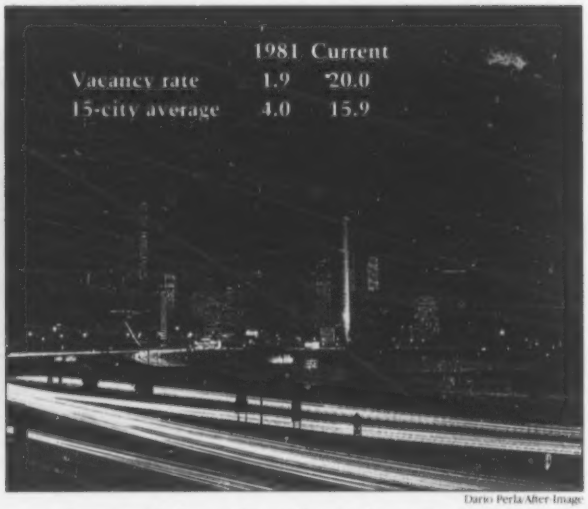
Since 1981 an average 300 million square feet of office space has gone up every year in the U.S., nearly double the annual rates of the 1970s. That's the equivalent of five Manhattans built in six frenzied years.

Few major city downtowns are not now plagued with mid-double-digit vacancy rates. And these numbers will only get worse in the next 18 months, because building continues in many cities. Only in the suburbs, with average vacancies already 24%, will the rates drop sharply, because construction is finally grinding to a halt.

Who will fill all this vacant space? A Massachusetts Institute of Technology study, looking at the next ten years, found that the white-collar labor force will likely be growing at only 1.7% a year. That compares with a 2.5% annual rate of growth from 1975 to 1985. That does not even take into account the effect of mergers and consolidations of large U.S. companies. Indeed, the nation's top 500 companies had 2.2 million fewer employees in 1985 than they did in 1980.

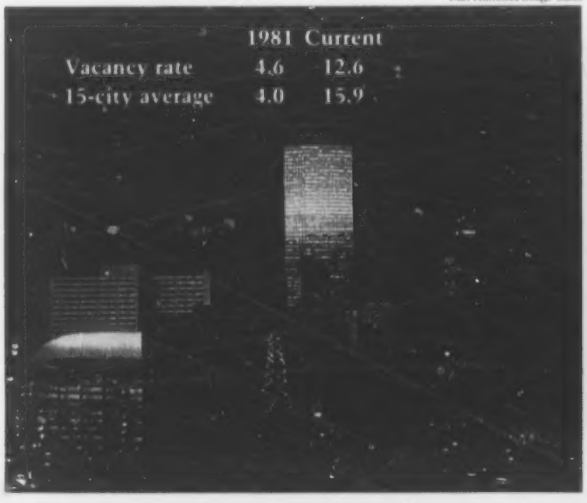
The outlook for hotels is just as grim as for office space.

Houston



Dario Perla/After Image

Dan Hummel/Image Bank



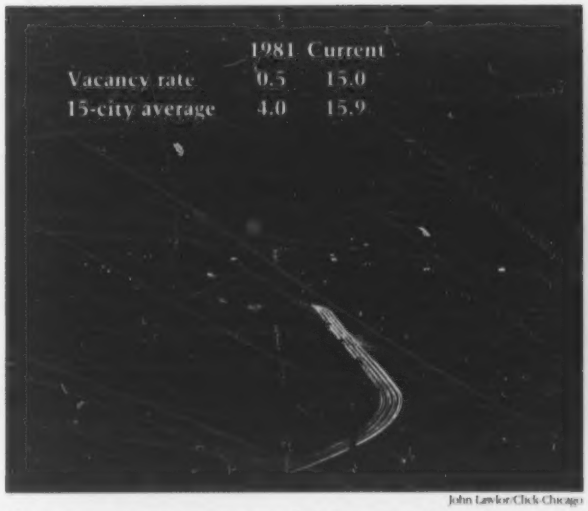
Minneapolis/St. Paul

Paul Chesley/Photographers Aspen

New York City

All vacancy rate data from Coldwell Banker for downtowns only.

Los Angeles



John Lawlor/Click Chicago

Occupancy rates are reported to be averaging a little over 64%, and heading down. Despite that, there was a net increase of 80,000 new hotel rooms last year. At the same time the break-even point for hotels continues to rise—to about 67% occupancy. There are 55,000 hotel rooms in smallish Orlando, Fla., to cite one example of particular excess. Only New York City and Los Angeles have more.

And let's not forget the short fuse burning in shopping centers, which over the last four years have accounted for nearly as many construction dollars as office buildings. The problems here will come in the smaller strip centers stretched along America's highways. Even in booming Florida, dozens are on the verge of bankruptcy.

So why haven't prices collapsed outside the oil-depressed states? Where are the screaming bargains in commercial real estate today? The answer is that relatively few properties have changed hands, so real prices have yet to be determined. Many banks, still hoping against hope, have yet to take their

David Hamilton/Image Bank

Philadelphia

Miami

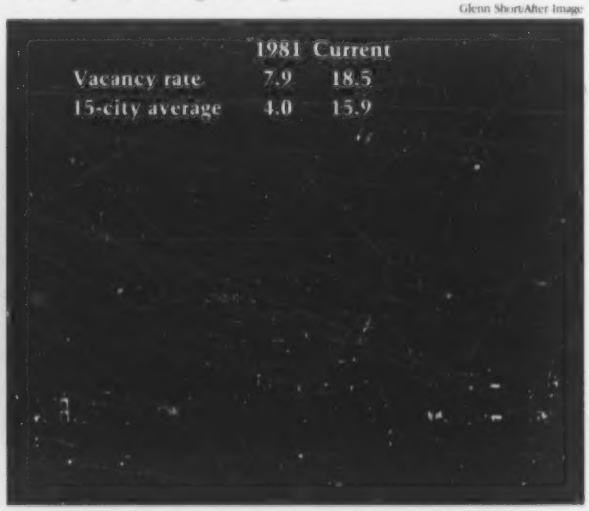
Dario Perla/After Image

full and heavy hits on their bad commercial real estate loans. An Oppenheimer & Co. study, for example, points out that there is a significant lag between the time high vacancy rates become apparent and when the banks are forced to write down their bad loans. Texas banks, for example, only last year began writing down the value of their construction and mortgage loans, even though extremely high vacancy rates had existed for two years.

The dramatic decline in interest rates over the past couple of years has also helped stall the decline in property values. Falling rates have allowed many developers cheaper refinancing, enabling them to hang in longer, try to rent their empty offices and get their cash flowing.

You will hear the optimists making the deep-pockets argument. Developers are bigger these days, they say. The big banks, insurance company and pension fund investors will all hang in until the glut is absorbed. These guys won't panic, the argument goes.

Glenn Short/After Image



Phoenix

That may be true if vacancy rates start dropping—or at least start to bottom out. Hardly likely in the cities, where scores of new projects will open their doors in the next 18 months. And the optimists are not yet considering the probability of rising interest rates or even the slightest recession in the next couple years. "Property values are likely to recover nicely in the next three years," says Kenneth Rosen, chief of real estate research at Salomon Brothers. "But our calculations do not foresee a recession."

Even absent a recession, some pension funds are starting to ask for their money back from insurance companies' real estate investment funds; that means some real estate pools may have to sell buildings. Banks will stop treating borrowers leniently. And after tax reform investors who signed nonrecourse notes may walk away from their partnerships.

Another problem with the deep-pockets argument: Many of the developers got so cocky they figured they could successfully branch away from the kinds of projects and the locations they knew well. As soon as one city got overbuilt, the availability of money enabled them to run off to another. Office developers built hotels. Apartment and hotel builders put up offices and shopping centers. William Criswell, in Dallas, who put up several successful Hyatt-Regency hotels in the Southwest, decided to build a $150 million office building, the I.M. Pei-designed Allied Financial Center, covered in greenish-blue glass, in downtown Dallas. The building is mainly vacant, and Criswell's real estate empire is in deep trouble.

San Francisco

George Hall/After-Image

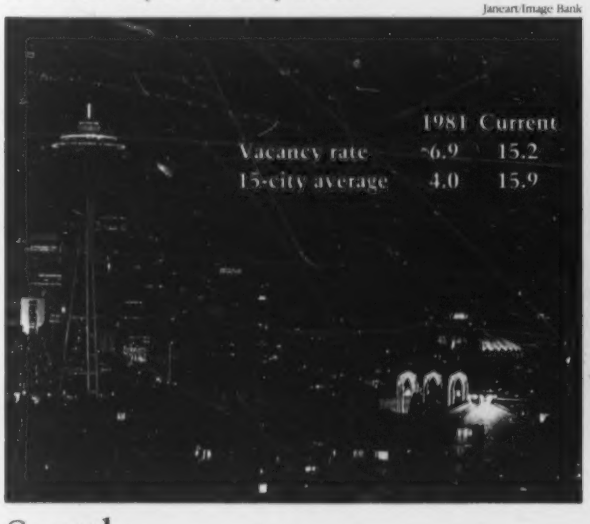
Trammell Crow, a crackerjack in office parks and apartments, scored big several years ago with his Anatole luxury hotel in Dallas. So he galloped out and set up the Wyndham group, building more luxury hotels in Florida, Texas and the Caribbean. But these did not do well—last month Crow sold control of four of his hotels to the Stouffer Hotel Co.

Until the early 1970s commercial real estate was not a get-rich-quick business. Owners held buildings for many years. Buildings were bought and sold based on solid, conservative cash-flow figures. Talk with Robert Greenberg of Minneapolis, whose family owns properties there and in other areas of the Midwest. The Greenbergs believe properties they own must produce real income, and as a result, in the last few years they were outbid on buildings by institutional investors and syndicators who made assumptions that a prudent business person ought not make.

But with tax reform, real estate will once again be for the long haul. Which is not to say that some real pros won't score big sooner. Take Sam Zell, for example, who calls himself "the grave dancer," for his knack for making money out of other people's mistakes. Zell recently bought a 960,000-square-foot Texas office building that cost Houston highflier Harold Farb $140 million. Zell's cost: $30 million, and he got the bank to refinance at a substantially lower interest rate.

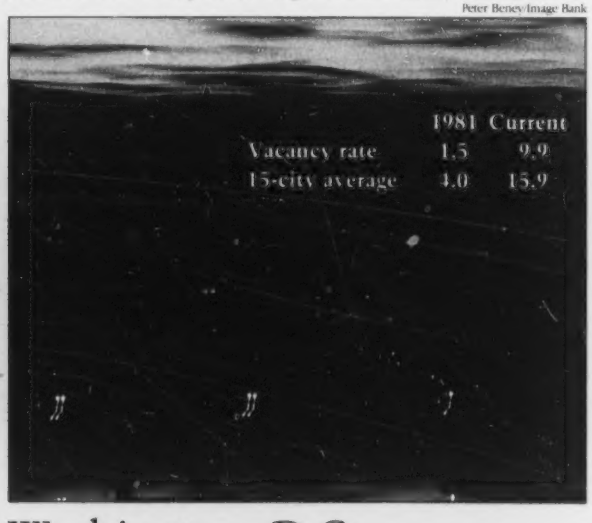
Zell expects to dance many a jig, before the slump is over, with similar deals. But the music is still too cheerful for his taste. Zell prefers dirges. Smart man, Sam Zell. ■

Janeart/Image Bank



Seattle

Peter Beney/Image Bank



Washington, D.C.

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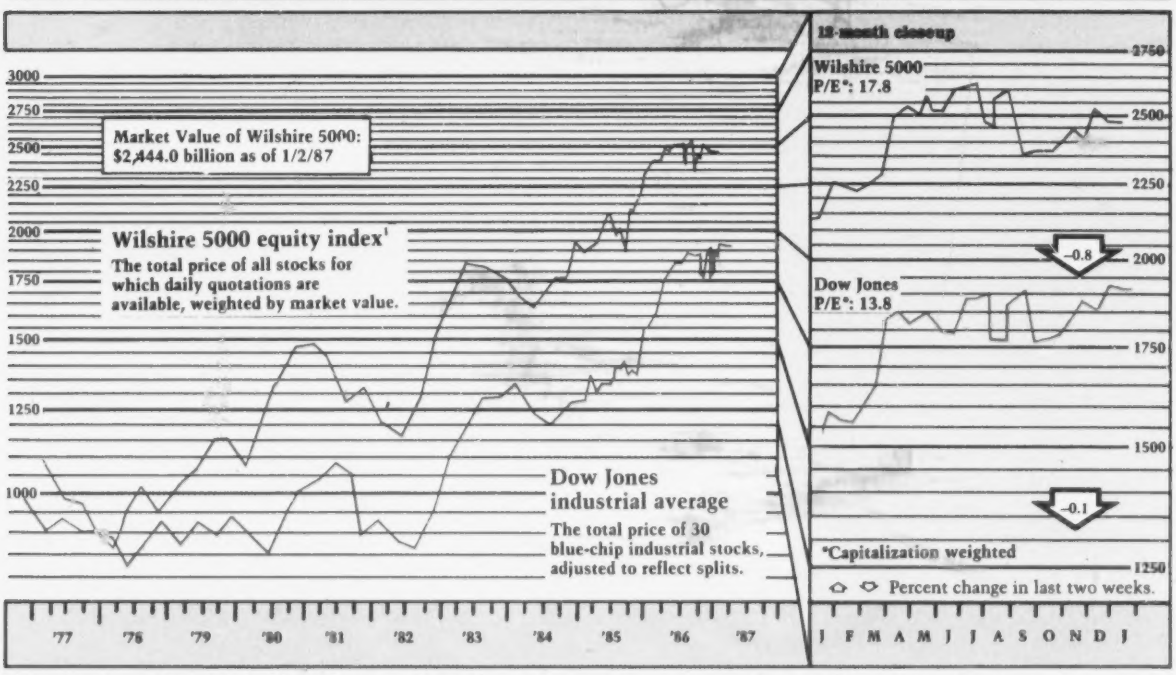
The Forbes/Wilshire 5000 Review

Edited by Steve Kichen


12-month closeup
Market Value of Wilshire 5000: $2,444.0 billion as of 1/2/87
Wilshire 5000 equity index[1]
The total price of all stocks for which daily quotations are available, weighted by market value.
Dow Jones industrial average
The total price of 30 blue-chip industrial stocks, adjusted to reflect splits.
Wilshire 5000 P/E*: 17.8
Dow Jones P/E*: 13.8
-0.8
-0.1
*Capitalization weighted
Percent change in last two weeks.
'77 '78 '79 '80 '81 '82 '83 '84 '85 '86 '87
J F M A M J J A S O N D J

Ships in the night. While blue-chip stocks took a short southern excursion, secondary shares moved in the opposite direction. For the two-week period the Dow industrials slipped 0.1% and the NYSE was off 1.1%. But Amex and Nasdaq issues posted respective gains of 0.8% and 0.3%. The overall market, as measured by the Wilshire index, fell 0.8%.

Are secondary shares about to start the next leg of the bull market? For all of last year Big Board issues gained 14%, vs. 7.4% for Nasdaq and 7% for Amex. During the last four weeks there were faint signs that more speculative stocks were preparing for a comeback. Our investor yardsticks, for example, show that high-growth issues rose 0.2% while low-growth shares fell 1.8%. And shares priced under $4 eked out a 0.1% gain while those priced over $40 fell 2.4%. For the Nasdaq and Amex to really catch fire, small technology stocks must break out of their long slump.

Closeup On The Equity Markets

Performance of six leading indexes

Percent change	Wilshire 5000	Forbes 500[2]	Dow Jones industrials	NYSE Composite	Amex Market Value Index	NASDAQ Composite
in last 4 weeks	–1.9	–2.1	0.1	–1.8	–0.1	–2.7
in last 52 weeks	14.4	11.8	24.4	16.1	8.0	8.5

Stock performance based on six key investor yardsticks

Percent change	Company size		Volatility[3]		P/E multiple		Dividend yield		Growth profile[4]		Share price	
	large	small	high	low	over 25	under 5	over 7.5%	none	high	low	over $40	under $4
in last 4 weeks	–2.7	0.2	–0.9	–0.9	–2.0	–1.1	–1.1	1.0	0.2	–1.8	–2.4	0.1
in last 52 weeks	18.3	31.8	37.9	22.1	9.5	19.0	14.8	26.9	31.7	24.0	23.0	14.6

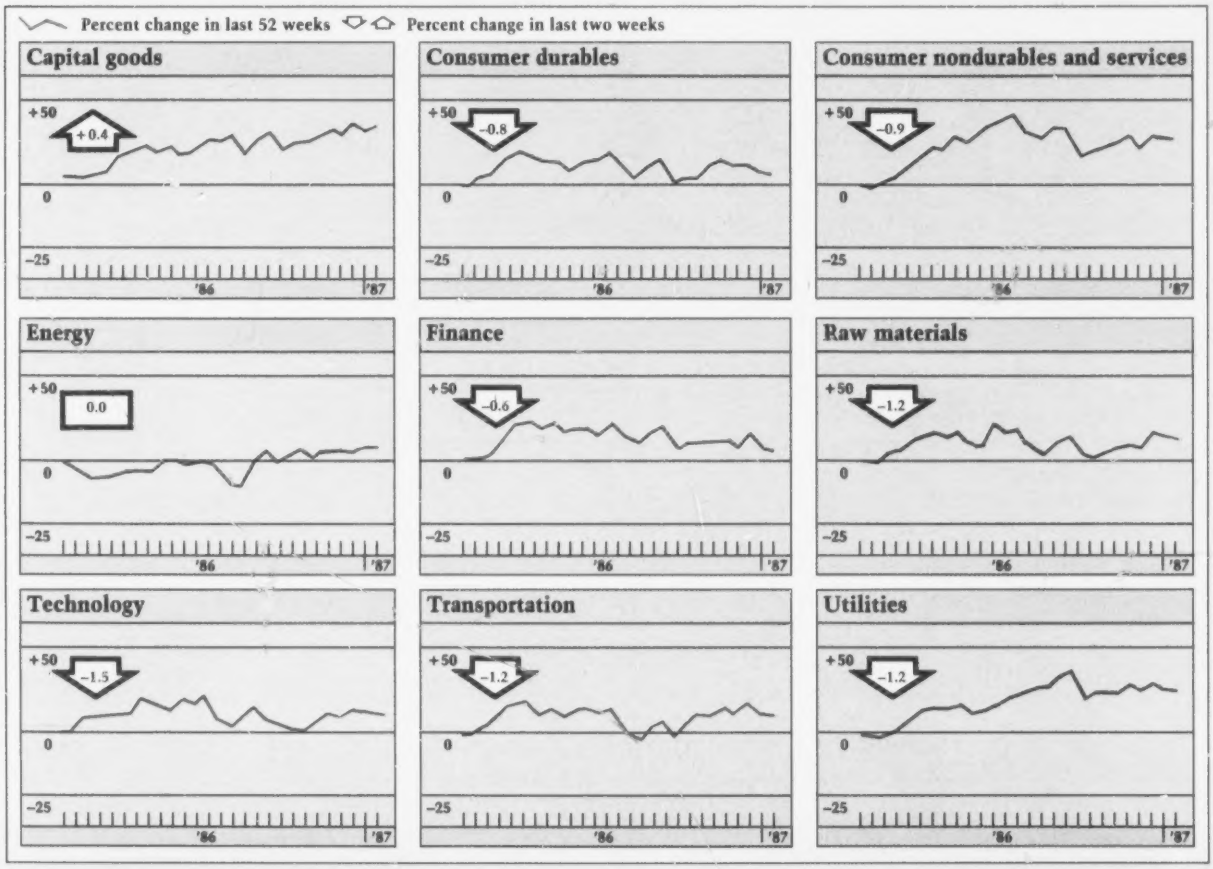
[1]Wilshire index reflects price performance. It differs slightly from market value of outstanding stocks because of retirements of equity since index was created. [2]Based on sales. [3]A stock's sensitivity to overall market movement. High-volatility issues have wide price fluctuations, low-volatility issues are more stable. [4]A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

Note: All data for periods ending 1/2/87. Prepared by Wilshire Associates, Santa Monica, Calif.

Where The Action Is

Time for technology? Bargain hunters should perhaps look at technology stocks, which fell 2.4% during the last 52 weeks, when the Wilshire index posted a gain of 14.4%. Although institutional favorite IBM fell 33½ points and reduced the market capitalization of the technology sector by more than $20 billion, there are plenty of technology stocks currently trading at below-market multiples. Examples: AST Research, 7; General Dynamics, 8.2; Altos Computer Systems, 9.

Also depressed are the energy, transportation and finance sectors, with below-market gains of between 7.5% and 9.2% last year. Consumer durables underperformed the market by a small margin. Three sectors—consumer nondurables, capital goods and utilities—beat the market.



What The Analysts Think

Pleasant dreams. Our first look at 1988 earnings forecasts shows that security analysts were quite generous in their long-term projections. The experts have the Forbes Sales 500 selling at less than ten times estimated earnings. But this multiple is likely to rise as more analysts contribute 1988 estimates and others scale back earlier forecasts.

Forecasting the Forbes 500

Performance period	Average earnings per share	P/E
latest 12 months	$2.64	16.2
1987 estimates	3.74	11.5
1988 estimates	4.35	9.9

Rank based on change in estimate	Sector	Estimated 1987 EPS	Estimated 1987 P/E	% change in 1987 estimate in 2 weeks	% change in 1987 estimate in 4 weeks
1	Consumer nondurables	$2.46	14.0	0.07%	0.10%
2	Transportation	2.64	11.0	-0.21	-1.02
3	Utilities	3.38	10.0	-0.30	-0.35
4	Finance	3.82	8.5	-0.36	-0.75
5	Raw materials	2.37	13.0	-0.38	-0.93
6	Capital goods	2.74	14.1	-0.40	-2.00
7	Consumer durables	3.55	11.9	-0.50	-2.20
8	Technology	2.90	12.4	-0.73	-1.41
9	Energy	2.37	14.2	-1.00	-1.62

Earnings projections are capitalization-weighted consensus estimates from over 2,000 security analysts. Data are compiled and updated continuously by the Institutional Brokers Estimate System (IBES), a service of Lynch, Jones & Ryan, a New York-based brokerage firm.

Note: All data for periods ending 1/2/87. Prepared by Wilshire Associates, Santa Monica, Calif.; IBES, a service of Lynch, Jones & Ryan, New York.